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No. 10,246

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

San Joaquin Valley Poultry Producers Association,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

REPLY BRIEF FOR PETITIONER.

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In its brief, petitioner pointed out that the amounts involved in this proceeding were not income to the petitioner, that they belonged to the individual producer members in proportion to their patronage, that they had been recognized by petitioner as accrued liability to the respective producers and had been appropriated and credited as an obligation to each individual producer in proportion to his patronage and so were proper deductions from gross income. In addition, petitioner was entitled to have been recognized as an exempt association.

Respondent in its reply brief has contended:

1. That petitioner is not tax exempt since (a) it realizes profit from its business with non-members, and

(b) there is no evidence that the reserve funds are reasonable reserves.

2. That the amounts placed in the reserves constitute income to petitioner and not to its members. Further that such amounts cannot be deducted from gross income since they have not been returned to patrons and since such deductions are solely a matter of administrative grace.

Even though petitioner were not an exempt corporation, the amounts concerned were not net income to it. They belonged to the member patrons and had been appropriated to them. Therefore petitioner will first consider respondent's contentions as to this.

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1. **RESPONDENT ERRS IN HIS CONTENTION THAT THE AMOUNTS IN QUESTION CONSTITUTE INCOME TO THE PETITIONER AND DO NOT BELONG TO THE MEMBER PATRONS.**

In all of the decided cases, even those cited by respondent, the question as to the nature of the funds was decided by the particular facts. These involved the Articles of Incorporation and By-laws of the association concerned, the statute under which it was organized as well as the acts of the association itself. The statutes under which this association is organized are noted in petitioner's brief (p. 12) and clearly provide that its operation shall be without profit to the association. The Articles of Incorporation of petitioner recognize this limitation (R. 95). The By-laws distinctly provide that the net proceeds belong to the

members (R. 124). This refers to all net proceeds whether they result from marketing or purchasing.

The Courts of California have specifically recognized that under such statute and such an organization the net proceeds belong to the members. Respondent's brief (p. 25) has incorrectly characterized the effect of *Bogardus v. Santa Ana Walnut Growers Association,* 41 Cal. App. (2d) 939, 108 Pac. (2d) 52. In that case the plaintiff did not seek to recover amounts due but sought to have a declaration of rights that other growers had no interest in the funds. The California Court held that under the cooperative statute these net proceeds were trust funds which belonged to the members who contributed their products in proportion to their contribution and that they remained the property of such persons even though they were not presently distributed. This clearly distinguishes this situation from those cases cited by respondent.

The decision in *Farmers Union Cooperative Company v. Commissioner,* 90 Fed. (2d) 488, was based upon the particular statute and by-laws concerned and the particular facts of that case. The Court there pointed out that the statute and the by-laws permitted earnings to be diverted to members or stockholders as such rather than to them as patrons. Section 1192 of the Agricultural Code of California specifically declares that they are not to have profit for themselves or for their members as members. That decision recognized that there would be a serious question whether these proceeds would constitute income within the Income Tax Amendment if the association there con-

cerned had been organized and operated on a cooperative basis. Here there can be no question as to the organization of this association on a cooperative basis nor as to its operation. That was conceded by respondent (R. 29). The other cases cited by respondent (p. 19) are clearly distinguishable from this case on the facts. They do not set down the general rule that proceeds belong to the association but looked to its organization and operation to determine this.

The By-laws of petitioner specifically state that net proceeds are the property of its member patrons and the By-laws constitute a contract with them. Every act of petitioner was in recognition of this situation. When the member joined the association, he was specifically advised that these net proceeds belonged to him (R. 146). He was advised that they might be used in reserve funds, and if they were, appropriate credit would be given to him for the amounts placed therein from the net proceeds belonging to him. The By-laws authorized the directors to create and maintain reserve funds, but the monies placed into these funds are the monies that belong to the producers who are entitled to the same and who have authorized and assented to their being placed in such reserve funds. The money so placed therein was not income to the petitioner. It was money belonging to the producers which they permitted the association to use. If the Board of Directors had attempted to use these funds for any other purpose than to place the same in duly authorized reserve funds, the individual producer would unquestionably have had a cause of action against the

association and would have been entitled to have immediate payment of the funds not used for the purpose assented to by him. The fact that the member permits this use of his portion of the net proceeds does not deprive him of these funds. He is permitting their use for working capital and is in the same position as if he had advanced that sum to the association from other sources and had received the association's promise to repay this advance in the due revolving of the fund into which it was paid. That is not income to the association. It is an indebtedness or liability which the association has concretely and explicitly recognized.

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2. RESPONDENT ERRS IN CONTENDING THAT THE AMOUNTS PLACED IN THESE RESERVE FUNDS WERE NOT DEDUCTIBLE AS PATRONAGE REFUNDS.

Respondent in support of its argument has here made the astounding statement that deductions of patronage refunds are solely a matter of *"administrative grace"* (italics ours) (Br. p. 22). Such a contention is destructive of our Democracy. Petitioner seeks these deductions as a matter of right because they do not represent true income of the association. They added no riches to petitioner because petitioner was under an accepted liability to pay them to the member patrons in the amounts credited to them. The allowance as deductions of the amounts appropriated for and declared as patronage refunds is based on the fact that these amounts really belong to the member patrons and constitute an indebtedness of the associa-

tion to them. Such amounts cannot be classified as income and are not taxable (Pet. Br. pp. 18, 19). It is because they are a liability of the association that they are recognized as deductions and this is not a matter of administrative grace. The Board of Tax Appeals in *Midland Cooperative Wholesale v. Commissioner,* 44 B. T. A. 824, 830, acknowledged that such deductions could only be allowed on that basis. It was not because of an official's whim. No one of the cases cited by respondent has ever expressed the view that these deductions were a matter of administrative grace. Congress has not delegated to any administrative official the authority to make that income which has heretofore been recognized as a liability and not income. In fact such a delegation of legislative power would clearly be unconstitutional (*United States v. Schechter Poultry Corporation, et al.,* 295 U. S. 495, 79 L. Ed. 1570). Yet respondent apparently assumes and exercises such power as a matter of administrative grace.

Respondent further argues that deductions are not permitted unless the amounts in fact have been returned to members during the taxable year (Br. p. 22). The cases he cites do not support this statement. The cited cases only required that the right to patronage refunds should have been declared.

In this case, the amounts claimed as deductions belonged to the member patrons by their contract with the association, and such amounts had been recognized as their property and as a liability of the petitioner

to them by resolutions of the Board of Directors, by book entries and by specific acknowledgment to the member patron through a written statement.

The amounts here in question were declared as part of the patronage refunds for the respective years 1936 and 1937. The resolutions of the Board (R. 137, 143) specifically recognized these amounts carried to reserves as an additional part of the patronage refunds belonging to member patrons and payable to them. Whether the producers received certificates or statements of indebtedness as acknowledgment of the liability of the association to them, it made no difference insofar as the individual member patron was concerned. The liability existed. The funds had been prorated to their credit and the obligation of the petitioner to them was definite in amount. No further action was required by the Board of Directors to make this liability or obligation complete (R. 74). The General Manager testified (R. 73) that if the funds in these reserves were expended for any purpose, the amounts represented still remained the property of the members and it would not affect the liability of the petitioner to them. This is the very essence of the revolving fund theory of operation. The funds provided by present members for capital purposes or working purposes may be so used and then as subsequent funds are provided by newer members, the earlier funds are paid out. The liability is always there. The time of payment depends upon the convenience and availability of cash funds for that purpose.

Respondent argues that until the proceeds are distributed, patrons have no greater interest in them than stockholders have in undistributed earnings of a corporation. This is not the fact. When the net proceeds have been determined, they belong to the member patrons not as members but as patrons and are held in trust for them by the petitioner. When the Board authorized, as it did, the appropriation and crediting of the respective sums to the member patrons, it created a liability to them which constituted them general creditors of petitioner to the amount of the refund due them. *Farmers Union Cooperative v. Commissioner,* 90 Fed. (2d) 488, recognizes that this interest ripens into ownership when the refund is declared.

Respondent is in error in stating that the existence and extent of the liability was not fixed by action of the taxpayer in the taxable years involved but was contingent upon future events (Respondent's Br. p. 24). The existence and extent of the liability was immediately fixed in the taxable years involved. The time of payment was deferred but this did not affect in any manner the right to the payment or the amount which the member patron would be entitled to receive. *Commissioner v. Brooklyn R. S. Corporation,* 79 Fed. (2d) 833, is of no authority here, for in that proceeding the bonus claimed by the General Manager was not entered on the books. Here the amounts were immediately entered on the books to the credit of the individual members. The Court there said that the test is whether the taxpayer is justified in entertaining a reasonable expectation that an expense would be

incurred or payment made in due course. Here there can be no question that the taxpayer expected to pay out these amounts to its members in due course. It was solvent, its operations each year were increasing and it had never failed in its obligations to its members so that there was no question that it had the right to expect that in due course these amounts would be revolved to the patron members in the amounts for which they had been credited and for which it was indebted.

Respondent states that *Midland Cooperative Wholesale v. Commissioner* (supra) is distinguishable but respondent has not been able to deny the facts quoted in appellant's brief (pp. 30 and 31) which show that there is no distinction between the cases. The amounts held in reserves, similar to amounts held in reserve in this case, were held to have been allocated to the individual members and not to be income of the association even though held in reserve. A careful reading of the cases shows that there is no distinction between the situations. The Board in the *Midland* case held there was no further corporate action necessary to create a liability and so it was not income. Here likewise no further corporate action was required to create the liability. All such action had been taken and the liability existed and was of record. If deductions are to be a matter of legal right and not of administrative grace, then upon the basis of that decision alone, the decision of the Board of Tax Appeals must be reversed.

CONCLUSION.

Respondent in his administrative capacity has classified as income net proceeds which belonged to member patrons and did not inure to the benefit of petitioner. These net proceeds were unequivocally acknowledged as a liability of petitioner to the individual producers in specific amounts as entered on the books of petitioner. The producers permitted such funds to remain with the petitioner as working capital. Such funds became part of revolving funds which would revolve so that the sum then definitely fixed and credited in the years in question would be paid to the producer. These amounts remained constantly an indebtedness of the petitioner to the individual producer. As a matter of right and not of administrative grace, petitioner submits that it is entitled to have these amounts recognized for what they were, amounts belonging to the producers, and not as net income of the petitioner.

Petitioner respectfully submits that the decision of the Board of Tax Appeals should be reversed.

Dated, San Francisco,
December 18, 1942.

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